

AMERICAN BANKER[®]

THE FINANCIAL SERVICES DAILY

Thursday January 26, 2012

COVER STORY

Fed's Low-Rate Strategy May Come at a High Cost

By Barbara A. Rehm

The federal funds rate has been near zero since late 2008 and on Wednesday federal policymakers said they plan to keep interest rates right where they are through 2014.

Keeping rates this low for that long will produce negative consequences. It's inevitable. What's a whole lot less certain is how policymakers plan to manage the downsides – or even how much attention they are paying to them.

"Everyone is so focused on jobs now and stimulating the economy," says Cam Fine, the president and CEO of the Independent Community Bankers of America. "At some point this becomes counterproductive. ... I don't know when the tipping point is, but I think we are pretty close. This essentially zero-interest-rate environment that the Fed is promoting is going to have a visible negative effect on this country."

Some victims are already obvious – retirees, pension funds, savers – and the Federal Reserve must figure that trade-off is worth it. If low rates succeed in goosing the economy, then everyone wins.

But it's not clear the Fed's strategy is working. Three-plus years of ultralow rates hasn't exactly jolted the economy to life.

"Have the low rates really stimulated much, and is it worth the price that we are going to pay long-term for it?" asks Bert Ely, an independent consultant in Alexandria, Va., who has earned a

reputation for seeing trouble around corners much earlier than others.

So what might be around the interest rate corner, particularly for banks?

The squeeze on profits from tighter margins is likely to feed cost-cutting, including layoffs and branch closings. "This extended low-rate environment is just hammering the hell out of community bankers, because they are margin bankers," Fine says.

Shareholders may decide to move their money to higher-yielding sectors, exacerbating the consolidation trend or adding to the failure tally.

"It is going to be hard for banks, especially smaller banks that don't have a lot of fee income, to earn a livable return on their deposits, and I think it's going to have a consolidation effect on the industry," says Wayne Rushton, a former chief national bank examiner who is now a managing director at Promontory Financial Group.

Bankers looking to bolster returns may be tempted to take bigger risks, particularly in lending. Loans put on the books at today's rates may adjust up when rates rise, and those borrowers may not be able to afford the higher payments. Any fixed-rate loans would quickly become unprofitable.

"We are seeing some evidence out there that banks have to go further out on the risk curve and begin banking borrowers that they wouldn't touch in other times," Rushton says. "And when rates go back up, the interest rates on those borderline borrowers will have



WAYNE RUSHTON
PROMONTORY FINANCIAL GROUP

to adjust as well, but they can't afford to pay the higher rates."

In other words, we may be sowing the seeds of the next credit crisis.

"Nobody can deny that rates are being kept artificially low, and that that ends up creating distortions," says veteran industry analyst Nancy Bush. "You cannot avoid distortions, and they build up the longer rates stay this low. People change their attitudes. They change their investment patterns. They change their measurement of risk and you start making miscalculations, and in the end those are going to catch up with you. I think it's a major problem."

Is anyone in government worrying about this? The Federal Open Market Committee met this week, so no one at the central bank was willing to be interviewed.

But Esther George, the president of

the Federal Reserve Bank of Kansas City, in a recent speech did note the trend toward bankers edging out on the risk curve. She also noted how hard it is for regulators to do much about it.

“Creating conditions that encourage the financial system to take on mispriced risk could lead to distortions that will only haunt us later,” George warned in the speech. “Preventing the mispricing of risk as it occurs is a tremendous challenge.”

George said monetary policymakers must “walk a fine line,” encouraging risk-taking to stimulate growth but keeping a close eye on “the mispricing of risk, the misallocation of capital and the ultimate weakening of financial firms’ balance sheets.”

This seems like just the sort of issue the Financial Stability Oversight Council would be all over. The council was created by the Dodd-Frank Act to detect drivers of systemic risk.

“Is FSOC worrying about these things? I assure you it’s not on their radar screen,” says Greg Wilson, a former Treasury

official turned industry consultant. “Why? They are too overwhelmed with doing just the minutiae of Dodd-Frank.”

While policymakers may not be pounding the bully pulpit, an inter-agency advisory on interest rate risk management was released Jan. 12. It answers a dozen questions regulators have been getting from bankers, including just how much a bank may rely on third-party vendors.

Regulators are telling bankers to be disciplined, to maintain their underwriting standards and to resist the temptation to reach for yield by buying longer-term securities.

“Nothing is free. Right now the immediate consequence [of low rates] is we have been watching margins grind down,” a senior federal regulator told me.

His main worry is that bankers will “go further out on the maturity spectrum.”

Funding higher-yielding, longer-term securities with cheap, short-term deposits will backfire when rates rise, the regulator says. The

assets will lose value, depositors will demand higher rates and the bank will be “trapped.”

“Once you lose that discipline and try and pick up a little bit of gain ... when rates do pop back up, it’s going to have a very harsh effect on the value of your holdings,” he says.

That brings us to the big question facing the Fed: when to raise rates.

The central bank has been criticized for inflating the real estate bubble by not raising rates fast enough.

“People look back and realize they stayed too low too long,” Ely says. “There ought to be attempts now made to try to get a better understanding of it and more discussion of it, and you know, there is hardly any. Most of the discussion is how can the Fed goose rates even lower, and what more can it do to stimulate the economy.”

Ely’s prediction: “There will be long-term unintended negative consequences that we can’t even begin to appreciate and won’t be able to fully understand for a decade or more.” ■